

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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date: May 23, 2008

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(Large & Mid-Size Business)

from: Roy A. Hirschhorn
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subject: Application of Notice 2007-29, 2007-1 C.B. 881

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Products =

Materials =

Year 1 =

Year 2 =

Year X =

Year Y =

ISSUE

Does Notice 2007-29, 2007-1 C.B. 881, preclude the Internal Revenue Service (Service) from examining whether or not costs removed from inventory are required to be capitalized to inventory under § 263A of the Internal Revenue Code?

CONCLUSION

No. Notice 2007-29 does not preclude the Service from examining whether or not costs removed from inventory are required to be capitalized to inventory under § 263A.

FACTS

Taxpayer manufactures and wholesales Products. Taxpayer is under examination for Years X through Y. Taxpayer filed a Form 3115 (Application for Change in Accounting Method) pursuant to Rev. Proc. 97-27, 1997-1 C.B. 680, in Year 1 seeking permission to discontinue capitalizing certain costs associated with Materials under § 263A and to elect to use the simplified production method under § 1.263A-2(b) to determine additional § 263A costs allocable to its ending inventory. In Year 2, Taxpayer received consent to expense currently certain costs associated with Materials and use the simplified production method to allocate additional § 263A costs to its ending inventory.

To currently expense certain costs associated with Materials, Taxpayer removed the costs from inventory by including negative amounts in the numerator of the ratio of the simplified production method. See § 1.263A-2(b). The Service is seeking to examine whether the removed costs from inventory were required to be capitalized and thus should not have been removed at all.

LAW AND ANALYSIS

Section 446 and § 1.446-1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in the manner that, in the opinion of the Commissioner, does clearly reflect income.

Section 1.446-1(e)(3)(ii) provides that the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their methods of accounting.

Section 263A(a) provides that the direct costs and indirect costs properly allocable to property that is inventory in the hands of the taxpayer must be included in inventory costs.

Section 1.263A-1(a)(3)(ii) provides, in part, that taxpayers that produce tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property's properly allocable share of indirect costs.

Notice 2007-29 was issued to address the controversy that has arisen regarding the means of removing costs from inventory that are not required to be capitalized to inventory under § 263A, and specifically, the removal of these costs from inventory by including negative amounts as additional § 263A costs in the numerator of the ratio of the simplified production method. The Service and Treasury requested public comments in Notice 2007-29 exploring options of how to resolve the controversy.

Notice 2007-29 provides that pending the issuance of additional published guidance, the Service will not challenge the inclusion of negative amounts in computing additional costs under § 263A or the permissibility of aggregate negative additional § 263A costs. Notice 2007-29 further provides that the issues of including negative amounts in computing additional costs under § 263A and the permissibility of aggregate negative additional § 263A costs will not be raised in any taxable year ending on or before publication of the additional guidance, and, if already raised as an issue in examination or before Appeals or the Tax Court in a taxable year ending on or before March 12, 2007, the issue will not be pursued by the Service.

Notice 2007-29 provides examples of costs, such as the excess of book depreciation over tax depreciation, that are not properly capitalized under § 263A, and addresses the means by which a taxpayer may remove such costs from inventory. The Notice does not change the rules under § 263A and the regulations as to which costs are required to be capitalized to inventory.

In this case, the Service is not challenging Taxpayer's means of removing costs from inventory, that is, the inclusion of negative amounts in the numerator of the ratio of the simplified production method. The Service is instead challenging whether or not the costs in question may be appropriately removed from inventory at all, that is, whether or not these costs are required to be capitalized to inventory under § 263A. If the costs are required to be capitalized to inventory, Notice 2007-29 does not transform such costs to currently deductible costs simply because Taxpayer is using negative amounts in the numerator of the ratio of the simplified production method as its means of removing the costs from inventory. Consequently, Notice 2007-29 does not preclude the Service from examining the issue of whether or not costs removed from inventory are required to be capitalized to inventory under § 263A, nor does it preclude the Service from making adjustments if it determines that Taxpayer did not capitalize costs to inventory which are required to be capitalized.¹

¹ However, we express no opinion as to whether the specific costs in question are in fact required to be capitalized under § 263A and the regulations or if the costs may be properly removed from inventory and treated as currently deductible. Our opinion is directed solely at the question of whether or not the Service is precluded from examining the issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4970 if you have any further questions.